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No. 89-235

In the Supreme Court of the United States

OCTOBER TERM, 1989

UNITED STATES OF AMERICA, PETITIONER

v.

ENERGY RESOURCES CO., INC.

UNITED STATES OF AMERICA, PETITIONER

v.

NEWPORT OFFSHORE, LTD.

ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

BRIEF FOR THE UNITED STATES

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QUESTION PRESENTED

Whether a bankruptcy court may require the Internal Revenue Service to apply tax payments made by a corporate debtor pursuant to its Chapter 11 plan of reorganization first to the trust fund portion of the corporation's tax liability, thereby relieving the corporation's responsible persons of their separate liability for those taxes.

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v.

ENERGY RESOURCES CO., INC.

UNITED STATES OF AMERICA, PETITIONER

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NEWPORT OFFSHORE, LTD.

ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-23a) is reported at 871 F.2d 223. In the *Energy Resources* case, the opinion of the district court (Pet. App. 24a-26a) is unreported; the opinion of the bankruptcy court (Pet. App. 31a-41a) is reported at 59 Bankr. 702. In the *Newport Offshore* case, the oral opinion of the district court (Pet. App. 27a-30a) is unreported; the opinion of the bankruptcy court (Pet. App. 42a-50a) is reported at 75 Bankr. 919.

JURISDICTION

The judgments of the court of appeals (Pet. App. 51a-52a) were entered on March 31, 1989. On June 19,

1989, Justice Brennan extended the time to petition for writs of certiorari to and including August 8, 1989. The petition was filed on August 7, 1989, and was granted on November 13, 1989. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTORY PROVISIONS INVOLVED

Section 105 of the Bankruptcy Code, 11 U.S.C. 105, provides in pertinent part:

Power of court

(a) The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. * * *

* * * * *

Section 1129 of the Bankruptcy Code, 11 U.S.C. 1129, provides in pertinent part:

Confirmation of plan

(a) The court shall confirm a plan only if all of the following requirements are met:

* * * * *

(9) Except to the extent that the holder of a particular claim has agreed to a different treatment of such claim, the plan provides that—

* * * * *

(C) with respect to a claim of a kind specified in section 507(a)(7) of this title [referring to priority tax claims], the holder of such claim will receive on account of such claim deferred cash payments, over a period not exceeding six years after the date of assessment of such claim, of a value, as of the effective date of the plan, equal to the allowed amount of such claim.

* * * * *

STATEMENT

These two cases were consolidated for purposes of argument and decision in the court of appeals. Each case involves a corporation that is in reorganization under Chapter 11 of the Bankruptcy Code (11 U.S.C. 1101 *et seq.*) and owes the government both trust fund and non-trust fund taxes. The trust fund taxes in issue are taxes withheld from the wages of employees and held by the employer in trust for the government under Section 7501 of the Internal Revenue Code (26 U.S.C.).[2] Each person responsible to collect, account for, and pay over trust fund taxes to the government who willfully fails to do so becomes personally liable under 26 U.S.C. 6672 for a penalty in the full amount of the unpaid trust fund taxes. Since the government collects the amount of the unpaid trust fund taxes only once (see *USLIFE Title Insurance Co.* v. *Harbison*, 784 F.2d 1238, 1243 (5th Cir. 1986)), the potential Section 6672 liability of each "responsible person" is reduced to the extent that delinquent trust fund taxes are paid by the corporation.

1. In January 1983, respondent Energy Resources Company and its affiliates filed petitions for reorganization under Chapter 11 of the Bankruptcy Code (11 U.S.C. 1101 *et seq.*). At that time, respondent owed about $1 million in taxes, most of which were trust fund taxes. Pet. App. 5a. Under Chapter 11 as in effect at that time, all of

[2] Sections 3102 and 3402 of the Internal Revenue Code (26 U.S.C.) require employers to deduct from wages certain amounts for the employees' income taxes and for the employees' portion of social security taxes. These amounts are to be "held * * * in trust" for the United States and later paid over to the government by the employer (26 U.S.C. 7501). Other corporate tax liabilities that are not withheld from employees' wages, such as corporate income tax and the employer's share of social security taxes, are referred to as "non-trust fund" taxes.

these taxes were entitled to a "sixth priority" (11 U.S.C. 507(a)(6) (1982)).[2] Chapter 11 requires as a condition of confirmation that the reorganization plan provide for payment of all priority tax liabilities over a period not to exceed six years (11 U.S.C. 1129(a)(9)(C)).

a. The bankruptcy court confirmed Energy Resources' third amended plan of reorganization. That plan provided that most of the debtor's assets would be transferred to the ERCO Liquidation Trust, and thereafter liquidated under the supervision of a liquidation trustee for payment to creditors of the estate. The plan provided for payment from the liquidation trust of prepetition tax claims, with interest, in four annual installments beginning on the anniversary of the confirmation date, October 1, 1984. The trustee could prepay the taxes at any time. Pet. App. 5a, 32a.

On November 6, 1985, the trustee transmitted a payment of the prepetition federal tax claims totalling $281,517. The trustee designated "that this payment be applied to the trust fund portion of the taxes, first for the period ended June 30, 1982 with the excess, if any, applied to the trust fund portion of the taxes for the period ended September 30, 1982." Pet. App. 33a. The Internal Revenue Service (IRS) refused to accept the trustee's designation, maintaining that it had the right to apply the payment to the corporate debtor's outstanding tax liability as it chose. The IRS informed the trustee by letter that, "[u]nless such direction of payment is given in a court order, the United States reserves the right to apply such payment[,] which is a distribution of a bankruptcy proceeding[,] to its maximum benefit." *Ibid.*

[2] Due to a 1984 amendment that added a new category of priority claims, priority federal tax claims are now seventh priority claims. See 11 U.S.C. 507(a)(7).

The trustee thereupon moved the bankruptcy court for an order directing the IRS to apply payments under the plan according to the trustee's designation. In his motion, the trustee argued that he was entitled to designate tax payments under the plan because the payments were "voluntary." He also contended that the designation of payments was necessary for the benefit of the bankruptcy estate. He stated that the designation enabled him to implement a settlement agreement entered into with Richard Rosen, a former officer of the debtor, in which Rosen immediately released $14,000 to the trust, assertedly in exchange for the trustee's agreement "to cooperate in designating tax payments which would forestall personal liability assessed by the IRS against the former officers from affecting them and their ability to cooperate with the Trustee" (Pet. App. 34a). The trustee also asserted that the designation would not harm the IRS because the plan provided, ultimately, for payment of the tax claims in full. The IRS opposed the trustee's motion on the ground that the payment of priority taxes under a Chapter 11 plan is "involuntary," and therefore the IRS is permitted to apply the payment as it chooses. *Id.* at 33a-34a.

b. The bankruptcy court granted the motion and ordered the IRS to follow the trustee's designation (Pet. App. 31a-41a). The court stated the general rule that a taxpayer who makes a "voluntary" tax payment is entitled to designate the manner in which it is to be applied, whereas that authority rests with the IRS if the payment is "involuntary" (*id.* at 34a). Relying on several other bankruptcy court decisions, the court held that "the mere filing of a claim in a Chapter 11 proceeding and the confirmation of a plan of reorganization do not constitute sufficient judicial action to render payment made pursuant to a Chapter 11 plan involuntary" (Pet. App. 36a), and that the trustee therefore was entitled to designate how the tax pay-

ment should be applied (*id.* at 36a-40a). The court also stated that its conclusion was buttressed by the government's failure to object to confirmation of the plan, even though the plan was silent on the question of designation or the manner in which the tax payments should be applied, because it was "foreseeable" that the trustee would seek such a designation (*id.* at 40a-41a).

c. On appeal, the district court affirmed (Pet. App. 24a-26a). The court stated that the bankruptcy court's role in confirming a plan under Chapter 11 does not make a tax payment thereunder involuntary, because the Bankruptcy Code affords debtors considerable flexibility in Chapter 11. Thus, in the district court's view, the bankruptcy "court here didn't compel action; rather, it approved a payment which a debtor wished to make" (Pet. App. 26a).

2. a. In the *Newport Offshore* case, respondent Newport Offshore filed a petition for reorganization under Chapter 11 on November 13, 1985, and continued operating as a debtor in possession. At the time of the petition, respondent owed about $300,000 in taxes, including both trust fund and non-trust fund taxes. The trustee proposed a plan of reorganization under which a third party, Allied Marine Associates, agreed to pay all of respondent's prepetition tax liability and various other debts, and to invest additional money in the corporation; in return, it would receive 85% of the shares of the new, reorganized Newport Offshore. The proposed plan provided for full payment of prepetition priority tax claims over a period of about six years. It further provided that these payments would be applied to extinguish all "trust fund" tax debts "prior to the commencement of payment of the non-trust fund portion" of the taxes (Pet. App. 5a). The government objected to the designation provision on the same grounds that it raised in *Energy Resources*. Pet. App. 4a-5a.

b. The bankruptcy court overruled the government's objection (Pet. App. 42a-50a). The court declined to adopt respondent's broad contention that tax payments under a Chapter 11 plan are always subject to designation by the debtor because there is no "enforced collection measure" that makes them involuntary (see *id.* at 45a-46a). Instead, the court concluded that whether a Chapter 11 debtor may designate its tax payments should be decided on a case-by-case basis according to the "totality of the facts and circumstances" (*id.* at 47a (citation omitted)).[3] The court expressed concern that, if payments of priority taxes in Chapter 11 cases were always held to be involuntary, it "would remove the initiative of [the debtor's] former principals to seek outside investors, who voluntarily inject needed cash into the estate, and would, as a consequence, either inhibit or eliminate altogether the likelihood of a viable Chapter 11 plan" (*id.* at 48a). The court concluded that the existence of third-party financing constituted "special circumstances" that justified including the trustee's requested designation provision in the plan here (*ibid.* (citation omitted)).

c. Ruling from the bench, the district court reversed and ordered the bankruptcy court to delete the designation provision from the reorganization plan (Pet. App. 27a-30a). Adopting the reasoning of the Third Circuit's decision in *In re Ribs-R-Us, Inc.*, 828 F.2d 199 (1987), the court stated that the policies of reorganization and collecting taxes were intended by Congress to "work together" so as to avoid a "double-whammy" loss in taxes to the government – namely, by allowing responsible officers to

[3] The court listed several factors that it regarded as relevant to this analysis, including: (1) the history of the debtor; (2) whether the IRS had taken any pre-bankruptcy collection measures; (3) the nature of the Chapter 11 plan; (4) the extent of administrative or court action; and (5) the "existence of exceptional or special circumstances warranting [the] allocation provided by the plan." Pet. App. 47a n.7.

escape Section 6672 liability while the government is required to credit employees with taxes withheld by their employer, but not paid over to the government (see Pet. App. 28a-29a). The court concluded that Congress "did not ever intend that a principal stockholder of a corporation in reorganization would have the ability to negotiate in the Bankruptcy Court an exculpatory provision with respect to the trust fund taxes" (*id.* at 29a-30a).

3. On consolidated appeals, the court of appeals affirmed in the *Energy Resources* case and reversed in the *Newport Offshore* case (Pet. App. 1a-23a). The court stated that, in accord with the Third Circuit in *Ribs-R-Us*, it "believe[d] that the law permits the IRS to call tax payments within a Chapter 11 reorganization 'involuntary,' for purposes of applying its own regulations" (*id.* at 6a). The court explained that whether payments made pursuant to a Chapter 11 reorganization plan should be characterized as "voluntary" or "involuntary" depends upon the degree of control the bankruptcy court has over the payments at issue, and it found that a Chapter 11 proceeding exhibits some characteristics that are "voluntary" and others that are "involuntary." Recognizing the deference due the IRS's interpretation on this matter, the court declared that it accepted the view that payments made pursuant to a Chapter 11 plan are "involuntary." *Id.* at 7a-12a. The court ruled, however, that this conclusion was not dispositive because it "only means • • • that the *IRS's own rules and regulations* do not *compel* it to accept the taxpayers' determinations as to how it must apply payments here at issue" (*id.* at 12a).

The court of appeals then proceeded to hold that the bankruptcy courts are empowered to require the IRS to apply the tax payments first to the trust fund tax liability. The court of appeals viewed the governing question as (Pet. App. 12a-13a): "Does a bankruptcy court possess the

legal power to order the IRS to apply a payment in a way that runs *counter* to IRS's own internal policies?" The court listed several factors it considered significant in concluding that bankruptcy courts do have power to override the IRS's traditional authority to apply involuntary tax payments as it chooses.

First and foremost, the court stated that "Congress has granted bankruptcy courts broad equitable powers" (Pet. App. 13a). In particular, the court pointed to the bankruptcy court's power to " 'issue any order, process, or judgment that is necessary *or appropriate* to carry out the provisions' of the Bankruptcy Code" (*ibid.*, quoting 11 U.S.C. 105 (emphasis by the court)). As an example of when "an order allocating Chapter 11 tax payments to 'trust fund' liabilities first would seem 'appropriate,' " the court posited the situation where the responsible officers offer to help rehabilitate the debtor by advancing funds, but "only if the court would assure them that the reorganized corporation would pay its 'trust fund' tax debts first" (Pet. App. 13a-14a). In that situation, the court reasoned, the bankruptcy court could determine that it should direct the IRS to apply the payment in accordance with the officers' demand on the theory that the diminished chances that the government would collect its entire tax debt would be outweighed by the increased chances that the debtor would "pay something to its general unsecured creditors" (*id.* at 14a).

In the court's view, the other factors that it listed buttressed this conclusion regarding the bankruptcy court's power. The court stated that bankruptcy courts have long had power to tell creditors how to apply payments against the debtor's several debts (Pet. App. 14a-15a) and that nothing in the Bankruptcy Code limits the bankruptcy court's designation power when the creditor is the IRS (*id.* at 15a-16a). The court reasoned that "it makes administrative sense for the bankruptcy court to have the power to determine, in some cases, the debt allocation of

Chapter 11 tax payments" because it is equipped to consider the effect of that determination on the debtor's prospects for rehabilitation and it already has the power to structure the timing of tax payments within the six-year constraint of 11 U.S.C. 1129 (Pet. App. 16a).

The court further noted that the IRS's policy of allocating payments first to non-trust fund taxes, while clearly calculated to maximize the collection of delinquent taxes, is not compelled by a statutory directive (Pet. App. 16a-17a). Finally, the court stated that it could "find no policy embodied in any specific statute, tax or otherwise, that either directly, or by manifesting a congressional intent, circumscribes a bankruptcy court's general powers in the respect at issue here" (*id.* at 17a). In particular, the court stated that the strong congressional policy of ensuring the collection of trust fund taxes embodied in 26 U.S.C. 6672 would not be undermined by its decision because the designation provided for the collection of trust fund taxes first, albeit at the expense of non-trust fund taxes that would go unpaid if the reorganization failed, whereas the IRS's allocation postponed the collection of trust fund taxes (Pet. App. 17a-20a). Suggesting that the policy of Section 6672 is "simply to check off the tax liabilities in [the government's] 'trust fund' books" as quickly as possible (*id.* at 19a), the court declared that "the IRS's argument seems to stand the policy of Section 6672 on its head" (*id.* at 18a).

Accordingly, the court of appeals concluded that the bankruptcy courts are empowered to order the allocation of involuntary tax payments in Chapter 11 proceedings. The court held that the allocation question should be determined by the bankruptcy court on a case-by-case basis, subject to review under the clearly erroneous standard. Pet. App. 21a. And the court specified the following as the appropriate inquiry (*ibid.*): "upon consideration

of the reorganization plan as a whole, in so far as the particular structure or allocation of payments increases the risk that the IRS may not collect the total tax debt, is that risk nonetheless justified by an offsetting increased likelihood of rehabilitation, *i.e.*, increased likelihood of payment to creditors who might otherwise lose their money?" The court concluded that it was unnecessary to remand the cases, holding that the bankruptcy courts' opinions indicated that they both would have upheld the requested designations under the foregoing standard (*id.* at 21a-23a).

SUMMARY OF ARGUMENT

A. 1. Section 6672 of the Internal Revenue Code (26 U.S.C.) is designed to protect against the misappropriation of taxes required to be withheld by employers and other third parties and then held "in trust for" (26 U.S.C. 7501) and paid over to the government. Under this provision, persons responsible for remitting these funds to the government who willfully fail to do so are individually liable for the amount of the unpaid "trust fund" taxes. Section 6672 liability acts as a deterrent to corporate officers who might be tempted to convert these trust funds to private use. It also protects the revenue by providing an additional source of collection when the trust fund taxes are not paid.

2. The IRS has long followed the policy of allowing taxpayers to designate how voluntary payments should be allocated among their various debts, but, in the case of involuntary payments, of allocating a partial payment as the IRS sees fit. When the IRS receives an involuntary payment from a taxpayer who owes both trust fund and non-trust fund taxes, it generally will apply that payment first to the non-trust fund liability, so as to preserve the alter-

nate source of collection in the event the corporation does not fully satisfy its liabilities. The IRS has applied this policy in the context of priority tax payments made pursuant to a Chapter 11 plan of reorganization; in doing so, the IRS has rebuffed the efforts of corporate debtors to designate the payments for application first to their trust fund liability—for the purpose of eliminating the Section 6672 liability of their responsible persons as quickly as possible.

The courts of appeals generally have agreed with the IRS's rejection of these designation requests, recognizing that priority tax payments pursuant to a Chapter 11 plan are "involuntary." By filing for protection under Chapter 11, the debtor gives up his freedom to deal with his property as he chooses; instead, the debtor must abide by the restrictions imposed by the Bankruptcy Code for the protection of creditors. In particular, the Bankruptcy Code requires as a condition of confirmation of the reorganization plan that all priority taxes be paid within six years of assessment (11 U.S.C. 1129(a)(9)(C)); if that condition, or other prerequisites to confirmation, cannot be met, the bankruptcy court must dismiss the Chapter 11 proceedings or liquidate the corporation (11 U.S.C. 1112(b)). Thus, the corporate debtor's payment of priority taxes essentially is made under threat of liquidation and in accordance with a reorganization plan with which the bankruptcy court has the power to order compliance. Accordingly, the payment cannot properly be regarded as "voluntary."

The ability of the IRS to reject the debtor's designation request in the Chapter 11 context is important to effectuating the policies underlying Section 6672. The requested designation would operate to prevent the government from protecting itself by applying corporate tax payments first to the non-trust fund liabilities, for which there is no separate source of collection. If the reorganization does not succeed, the government would then have to

bear the loss of the unpaid non-trust fund taxes. Thus, the designation would shift the risk of failure of the reorganization from the responsible officers, whose misconduct created the trust fund delinquencies in the first place, to the government. Moreover, if responsible officers had reason to believe they could ultimately escape Section 6672 liability under cover of Chapter 11 if the corporation's financial difficulties prove insurmountable, the disincentive to plunder the trust fund to aid the struggling corporation would be greatly reduced. Thus, requiring the IRS to abide by a corporate debtor's designation of Chapter 11 payments would weaken the corporation's incentive to pay its taxes voluntarily, rob Section 6672 of much of its effectiveness, and directly undermine the Commissioner's ability to maximize the collection of delinquent taxes.

B. 1. Although the court of appeals accepted the IRS's characterization of priority tax payments under a Chapter 11 plan as involuntary, and therefore did not dispute that the IRS is not required to honor the debtor's designation, the court erred in holding that the bankruptcy court nevertheless is empowered to direct the IRS to honor a designation that such payments first be applied to trust fund liabilities. Contrary to the court's suggestion (Pet. App. 14a), there is no authority for the proposition that bankruptcy courts have inherent power to implement general equitable principles by directing creditors how to apportion partial payments. Nor does the Bankruptcy Code confer such wide-ranging authority on bankruptcy courts.

No provision in the Bankruptcy Code expressly grants this power, and the court of appeals erred in reading such an authorization into 11 U.S.C. 105. That general provision speaks to the procedural powers of the court, permitting it to implement the substantive provisions of the Bankruptcy Code by issuing equitable orders such as injunctions and stays. Section 105, however, "does not au-

thorize the bankruptcy courts to create substantive rights that are otherwise unavailable under applicable law, or constitute a roving commission to do equity" (*United States* v. *Sutton*, 786 F.2d 1305, 1308 (5th Cir. 1986) (footnote omitted)).

Although the Bankruptcy Code provides many opportunities for debtors to reorganize, rather than liquidate, it does not establish rehabilitation of the debtor as an unqualified goal. In particular, Congress has determined that payment of delinquent priority taxes must take precedence over rehabilitation, and that a debtor cannot proceed with a reorganization plan unless it provides for full payment of priority taxes. Therefore, the bankruptcy court's power to enter orders necessary to implement the provisions of the Bankruptcy Code plainly does not give it unbridled authority to enter any order that would facilitate rehabilitation. The court cannot upset the balance carefully established by Congress by ordering the IRS to make an allocation designed to advance the interests of general creditors at the acknowledged expense of the government's ability to collect priority taxes.

2. The court of appeals' decision would also undermine the policies reflected in Section 6672, which are critical to the integrity of the withholding tax system. Congress has recognized that allowing a responsible person to avoid his Section 6672 liability in bankruptcy proceedings would vitiate that provision's effectiveness as a deterrent and as an alternate source of collection. Accordingly, Section 6672 liabilities are given priority and are nondischargeable in a responsible officer's personal bankruptcy proceeding. It is not appropriate for the bankruptcy court to allow the same officer—through the threat of noncooperation with the corporate debtor's reorganization—to achieve in the corporate reorganization proceeding the personal relief not available in his own bankruptcy proceeding. The court of appeals' rule would similarly undermine the deterrent value of Section 6672. Thus, the decision below would frustrate the congressional design embodied in both Section 6672 and the Bankruptcy Code to deter the conversion of trust funds to personal use and to protect the Treasury against loss from such misappropriations.

ARGUMENT

THE GOVERNMENT IS NOT REQUIRED TO APPLY PRIORITY TAX PAYMENTS RECEIVED UNDER A CHAPTER 11 PLAN FIRST TO THE DEBTOR'S TRUST FUND TAX LIABILITY

Under Section 6672 of the Internal Revenue Code (26 U.S.C.), corporate officers responsible for remitting federal taxes that have been withheld by an employer from the wages of its employees are personally liable for the amount of these "trust fund" taxes that they fail to turn over to the government. This provision reflects the fact that these funds are not the property of the corporation; to the contrary, these funds are held in trust for the government. Section 6672 operates to deter responsible persons from converting these funds for private use and to provide an alternate source for collection of the withheld taxes in the event that the funds are so converted. The court of appeals in this case has substantially weakened the practical effect of Section 6672 by allowing responsible officers who convert trust funds to private use to manipulate corporate bankruptcy proceedings to reduce or eliminate their individual liability—at the acknowledged expense of the government's ability to collect its delinquent taxes from the corporate debtor.

The court of appeals held that a bankruptcy court has discretion to allow a corporate debtor in Chapter 11 proceedings to designate priority federal tax payments under its reorganization plan for application first to its trust

fund tax liability. The practical effect of such a designation is that payments of priority taxes under Chapter 11 plans redound first to the benefit of responsible corporate officers, not to the government; if the reorganization plan is not successfully completed, the government is left with an uncollectible non-trust fund tax claim, while the corporate officers have been relieved of their trust fund liability to the extent tax payments have been made. As an example of the circumstances in which it would be appropriate for a court to so exercise its discretion, the court of appeals posited the situation in which the responsible officers require such a designation provision as a condition of their cooperation with the reorganization. Thus, the decision below allows corporate officers to plunder the government's trust fund for private use and then, after the funds have disappeared and the corporation has gone bankrupt, to use the threat of noncooperation with the reorganization to have scarce corporate resources applied first to annul their separate liability for trust fund taxes, rather than to satisfy the corporation's other delinquent tax liabilities. There is no authority vested in the bankruptcy court to effect this untoward result, which undermines the congressional design embodied in both Section 6672 and the Bankruptcy Code.

A. The Government Is Not Obligated To Honor A Corporate Debtor's Request That Its Priority Tax Payments Under A Chapter 11 Plan Be Applied First To Trust Fund Tax Liability

1. Congress has determined that several kinds of taxes, notably the employee's portion of social security tax and employee income tax, should be collected by a third party and then paid over to the government (see 26 U.S.C. 3102, 3402).[4] Although employers are required by law to

[4] Other taxes of this type include income taxes on certain sweepstakes or gambling winnings (26 U.S.C. 3402(q)(1)) and excise taxes on communication services and transportation by air (26 U.S.C. 4291).

hold these collected funds as "a special fund in trust for the United States" (26 U.S.C. 7501), Congress recognized that corporate employers might be tempted to use these funds for private purposes and then fail to turn them over to the government. See *United States* v. *Sotelo*, 436 U.S. 268, 277 n.10 (1978). These trust fund delinquencies have a serious effect on the Treasury because the employees must be credited with payment of the withheld amounts as if the trust funds were in fact remitted to the government. See 26 U.S.C. 31(a); *Slodov* v. *United States*, 436 U.S. 238, 243 (1978). As a result, the government may be required to issue refunds to these employees or to distribute social security benefits to them, based upon tax payments that were never received by the government.

To protect against the danger of misappropriation of trust fund taxes, Congress enacted what is now 26 U.S.C. 6672, imposing personal liability in an amount equal to the unpaid trust fund taxes upon responsible persons who willfully fail to collect and remit these taxes to the government.[5] This provision aids the collection of trust fund taxes in two ways. First, the specter of personal liability acts as a deterrent to the corporate officers who might be tempted to use the withheld amounts for operation of the corporation; thus, the prospect of Section 6672 liability helps "to assure compliance by the employer with its ob-

[5] Section 6672 provides that "[a]ny person required to collect * * * and pay over any tax * * * who willfully fails to collect such tax, or truthfully account for and pay over such tax, * * * shall * * * be liable to a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over." This imposition of personal liability dates back to the earliest years of the federal income tax. See *Slodov* v. *United States*, 436 U.S. at 248 n.10.

ligation to withhold and pay the sums withheld" (*Slodov* v. *United States*, 436 U.S. at 247). Second, in cases where the responsible persons nonetheless fail to pay over withheld taxes, Section 6672 provides an "additional source for collection" so that the government does not necessarily suffer a loss if it cannot collect from the corporation. See, *e.g.*, *DuCharmes & Co.* v. *Michigan*, 852 F.2d 194 (6th Cir. 1988); *In re Technical Knockout Graphics, Inc.*, 833 F.2d 797 (9th Cir. 1987).

Although the individual's liability under Section 6672 is separate and distinct from that of the corporation, it is the longstanding policy of the IRS not to retain payments that exceed the amount of unpaid trust fund taxes. This policy accords with the congressional goal underlying Section 6672 to guarantee collection of withholding taxes. Thus, the liability may be collected in part from one or more responsible persons and in part from the corporate employer, or it may be collected entirely from one of those sources, but the IRS will not seek to do more than make itself whole for the withheld amounts that it must credit to the employees' accounts. See *United States* v. *Sotelo*, 436 U.S. at 279 n.12; *USLIFE Title Insurance Co.* v. *Harbison*, 784 F.2d 1238, 1243 & n.7 (5th Cir. 1986); Policy Statement P-5-60 (approved May 30, 1984, and its predecessor approved June 2, 1977), *Policies of the Internal Revenue Service Handbook*, [1 Administration] Internal Revenue Manual (CCH), at 1305-14 (Mar. 1989).[6] As a

[6] As a general rule, the IRS will seek to collect from the corporation before proceeding against the responsible persons. The IRS is not required, however, to exhaust its remedies against the corporation before it attempts to collect from the responsible persons. Thus, it is no defense to the imposition of Section 6672 liability that the taxes might still be collected from the corporation or the assets of its bankruptcy estate. See *Calderone* v. *United States*, 799 F.2d 254, 257-258 (6th Cir. 1986).

result, the responsible person's Section 6672 liability is reduced *pro tanto* by corporate payments of delinquent trust fund taxes.

For this reason, where a corporation owes both trust fund and non-trust fund taxes, it is in the government's fiscal interest to apply a partial payment to the non-trust fund liability—thereby preserving the alternate source of collection for the trust fund portion of the liability in the event the corporation cannot make full payment. Accordingly, when the IRS is determining how to allocate such a partial payment, its policy generally is to apply it first to non-trust fund taxes due the government. See, *e.g.*, *In re Ribs-R-Us, Inc.*, 828 F.2d 199, 201 (3d Cir. 1987); *United States* v. *DeBeradinis*, 395 F. Supp. 944, 952 (D. Conn. 1975), aff'd, 538 F.2d 315 (2d Cir. 1976) (Table) (if he failed to apply funds first to non-trust fund liabilities, the Commissioner would "shirk his responsibility to insure that the maximum amount of assessed tax be collected").

2. It is a well settled rule of common law that a debtor has authority to direct his creditor how to apply a partial payment voluntarily made. If the debtor does not make such a designation, then the creditor can apply the partial payment as he sees fit. See, *e.g.*, *National Bank of the Commonwealth* v. *Mechanics' Nat'l Bank*, 94 U.S. 437 (1876); *Field* v. *Holland*, 10 U.S. (6 Cranch) 8, 27 (1810). It is also well established that when the debtor makes the payment involuntarily, he has no right to direct the allocation of the payment among his various debts. See generally 70 C.J.S. *Payment* § 37 (1987); 60 Am. Jur. 2d *Payment* § 103 (1987). In line with these principles, the IRS has long distinguished between voluntary and involuntary payments in ascertaining when it has power to determine which outstanding tax liabilities are satisfied by particular payments. The IRS permits taxpayers to designate the application of "voluntary" tax payments, but "involuntary"

payments are applied according to the IRS's own determination. See, *e.g.*, *Amos* v. *Commissioner*, 47 T.C. 65, 69 (1966); Rev. Rul. 73-304, 1973-2 C.B. 42; Rev. Rul. 73-305, 1973-2 C.B. 43, modified by Rev. Rul. 79-284, 1979-2 C.B. 83; Rev. Rul. 58-239, 1958-1 C.B. 94.[7]

This policy encourages taxpayers to make voluntary payments, thereby sparing the government the expense of pursuing collection by administrative levy or in judicial proceedings. See *Amos* v. *Commissioner*, 47 T.C. at 70. And in the trust fund context in particular, this policy encourages responsible persons to resist the temptation to raid the government's trust funds to pay other business expenses when a corporation is in financial distress. If they instead pay the amount of the withheld taxes voluntarily, the responsible persons can avoid personal liability by designating the payment for application to the trust fund liability. The IRS's policy of designating the application of involuntary tax payments generally has not been disputed, and it has been regarded as "uniformly followed by the courts" (*Muntwyler* v. *United States*, 703 F.2d 1030, 1032 (7th Cir. 1983)). See also *O'Dell* v. *United States*, 326 F.2d 451, 456 (10th Cir. 1964); *Amos* v. *Commissioner*, 47 T.C. at 69-70.

Applying this established policy, the Commissioner has taken the position that a corporate debtor may not designate the application of its priority tax payments under a Chapter 11 plan because such payments are "involuntary," and that position has been upheld by the courts of appeals. See *DuCharmes & Co.* v. *Michigan*, 852

[7] An involuntary payment for these purposes traditionally has been defined as "any payment received by agents of the United States as a result of distraint or levy or from a legal proceeding in which the Government is seeking to collect its delinquent taxes or file a claim therefor" (*Amos* v. *Commissioner*, 47 T.C. at 69).

F.2d 194 (6th Cir. 1988); *In re Technical Knockout Graphics, Inc.*, 833 F.2d 797 (9th Cir. 1987); *In re Ribs-R-Us, Inc.*, 828 F.2d 199 (3d Cir. 1987); but see *United States* v. *A & B Heating and Air Conditioning, Inc.*, 823 F.2d 462 (11th Cir. 1987), vacated, 108 S. Ct. 1724 (1988), on remand, 861 F.2d 1538, 1539-1540 (11th Cir. 1988), further opinion, 878 F.2d 1311 (11th Cir. 1989). When a bankruptcy petition is filed, the debtor receives the protection of an automatic stay and other benefits, but in exchange it assumes significant limitations on its freedom of action. As the Third Circuit observed, "[d]ebtors who file under *any* chapter of the bankruptcy code have few, if any, options" (*In re Ribs-R-Us, Inc.*, 828 F.2d at 203 (internal quotation omitted)). Upon filing a petition for relief under the Bankruptcy Code, the debtor's property, as well as subsequently acquired property, becomes the property of the bankruptcy estate. 11 U.S.C. 541(a). The bankruptcy trustee, or the debtor in possession if a trustee is not appointed, holds this property in trust for the benefit of creditors. Therefore, he cannot deal with the property solely for the advantage of the debtor, but rather is bound to respect the priorities and other restrictions imposed by the Bankruptcy Code for the protection of creditors. See generally 11 U.S.C. 1106, 1107; S. Rep. No. 989, 95th Cong., 2d Sess. 116 (1978); *Wolf* v. *Weinstein*, 372 U.S. 633, 649-650 (1963); *In re* [illegible]. *Technical Knockout Graphics, Inc.*, 833 F.2d at 802-803; *In re Ribs-R-Us, Inc.*, 828 F.2d at 202-203.

Once there is a confirmed Chapter 11 plan of reorganization, the debtor does not have the option to decline to pay priority taxes. Section 1129(a)(9)(C) of the Bankruptcy Code establishes as a condition for confirmation of the reorganization plan that it provide for payment by the debtor of all seventh priority taxes within six years from the date of assessment. Although the debtor or trustee has

some degree of " 'latitude' as to 'how and when the IRS will be paid' " (Pet. App. 11a (quoting *In re Lifescape, Inc.*, 54 Bankr. 526, 528 (Bankr. Colo. 1985)), it remains an absolute requirement that the plan propose to pay priority taxes in full on terms at least as favorable as those specified in Section 1129(a)(9)(C). See *In re Ribs-R-Us, Inc.*, 828 F.2d at 203 & n.3. In short, a corporate debtor pays its priority taxes under a Chapter 11 plan of reorganization because it is compelled to do so as a condition of the reorganization. Furthermore, if a feasible reorganization plan that complies with statutory requirements cannot be developed, the Chapter 11 proceedings must be either dismissed or converted to Chapter 7 liquidation proceedings. 11 U.S.C. 1112(b). Thus, the corporate debtor's payment of priority taxes essentially is made under threat of liquidation; that payment cannot reasonably be regarded as "voluntary."

Moreover, the considerable extent of judicial involvement in a Chapter 11 proceeding makes the payment of priority taxes under a reorganization plan closely akin to a payment pursuant to a judgment in a collection suit, which is unquestionably an involuntary payment. The bankruptcy court has authority to determine the amount of the debtor's tax obligations (11 U.S.C. 505), which in turn determines the amount of payments under the plan that must be set aside for delinquent priority taxes; moreover, the court is obligated to reject any proposed plan that falls short of the statutory requirement for payment of priority taxes (11 U.S.C. 1129(a)(9)(C)). Once the court confirms the plan, it has the power to compel compliance (11 U.S.C. 105(a), 1142). Thus, the confirmed plan is the equivalent of a court order requiring the debtor to pay its creditors according to a specified schedule. See *In re Ribs-R-Us, Inc.*, 828 F.2d at 203. In short, once a debtor decides to avail itself of the protection of Chapter 11 and submits itself to the jurisdiction of the bankruptcy court

for that purpose, it has no choice but to pay its priority tax obligations; a characterization of such payments as "voluntary" cannot be reconciled with the realities of the debtor's situation and the restrictions imposed by the Bankruptcy Code.

In addition, payments made pursuant to a Chapter 11 plan fall within the traditional definition of involuntary payments and the general policies that counsel against allowing a taxpayer to designate such payments. To collect its priority taxes in bankruptcy, the IRS, at a minimum, is required to file claims and to monitor the bankruptcy proceedings. Thus, when it receives taxes by means of payments under Chapter 11, the government is not spared the expense of collection, as it is with a genuine voluntary payment, which merely is posted to the taxpayer's account. And the payment of a priority tax claim pursuant to a Chapter 11 plan confirmed by the bankruptcy court meets the recognized definition of an involuntary payment; it is received "from a legal proceeding in which the Government is seeking to collect its delinquent taxes or file a claim therefor" (*Amos* v. *Commissioner*, 47 T.C. at 69).

The policies that underlie Section 6672 and the IRS's practice of declining to allow taxpayers to designate involuntary tax payments for application first to trust fund tax liability are strongly implicated in the Chapter 11 context. A corporate debtor's ability to designate its Chapter 11 tax payments in this manner would substantially erode the protection afforded the public fisc by Section 6672 at a time when that protection is most critical—namely, when the corporation is so beset by financial difficulties that it must seek relief in the bankruptcy courts. Although Section 6672 is designed to assist the government in the collection of tax delinquencies, the designation provision would have the opposite effect. The government would be unable to protect itself by applying the corporate tax payments to the corporation's non-trust fund tax liabilities, while at

the same time retaining the ability to collect unpaid trust fund delinquencies from the persons responsible for creating the delinquencies. In the event the reorganization is not successful and the corporate tax liability is not paid in full, the government could not resort to the responsible persons to make itself whole, but would have to bear the loss of the priority taxes that the corporate debtor did not pay. In effect, the designation would shift the risk of failure of the plan from the responsible officers, whose improper conduct created the trust fund delinquency, to the government.

In addition to undermining the efficacy of the alternate source of collection established by Section 6672, allowing the corporate debtor to designate its Chapter 11 payments would greatly weaken the disincentive for the responsible persons to create the trust fund tax delinquency in the first place. If the responsible persons have reason to believe that they ultimately can escape Section 6672 liability under cover of Chapter 11 if the corporation's financial difficulties prove insurmountable, the statute will not deter them from using the trust fund in a last-ditch effort to save a failing corporation. Moreover, the responsible persons would have little incentive to satisfy trust fund deficiencies prior to bankruptcy if they retain the power to designate, as if made voluntarily, payments made only as required by statute as a condition of the confirmation of a reorganization plan. Thus, requiring the IRS to abide by the corporate debtor's designation of Chapter 11 payments would weaken the corporation's incentive to pay its taxes voluntarily, rob Section 6672 of much of its effectiveness, and directly harm the Commissioner's ability to maximize the collection of delinquent taxes. Accordingly, as the courts of appeals have held, the established rule regarding the apportionment of involuntary tax payments should be applied to permit the IRS to allocate priority tax payments

under a Chapter 11 plan as it sees fit, without regard to the corporate debtor's request that the payments be applied first to trust fund liabilities.

B. The Bankruptcy Court Lacks Authority To Direct The IRS To Apply A Corporate Debtor's Chapter 11 Tax Payments So As To Minimize The Responsible Persons' Section 6672 Liability At The Expense Of The Government's Ability To Maximize The Collection Of Delinquent Taxes

The court of appeals expressed no disagreement with the principles discussed above or with their application to this case. The court did not question the IRS's established practice of allocating involuntary tax payments among various outstanding delinquencies as the IRS determines is appropriate (see Pet. App. 7a-9a). The court also "accept[ed] [the IRS's] view" that priority tax payments under a Chapter 11 reorganization plan are "involuntary" (*id.* at 12a). Thus, the court of appeals agreed that the IRS is not required to honor a corporate debtor's designation of its Chapter 11 priority tax payments. The court held, however, that the *bankruptcy court* has authority to direct the IRS how to apply the debtor's tax payments, and that it can order the IRS to apply those payments to minimize the Section 6672 liability of the responsible officers, notwithstanding the detrimental effect on the public fisc, if it believes that such an allocation will contribute to the prospects for a successful reorganization that will benefit unsecured creditors. This holding is erroneous.

1. Citing *National Bank of the Commonwealth* v. *Mechanics' Nat'l Bank, supra,* the court of appeals stated that "bankruptcy courts have long had the legal power to tell creditors against which of a debtor's several debts they are to apply a particular payment" (Pet. App. 14a). This broad statement simply cannot be supported. Nothing in this Court's decision in *National Bank of the Common-*

wealth suggests that a bankruptcy court can direct a creditor how to apply a partial payment among several debts having equal priority. The statement by this Court relied upon by the court of appeals is no more than an almost verbatim restatement of the rule—noted by this Court in several earlier cases[8]—that allocation of a voluntary payment may be directed in the first instance by the debtor or, if he fails to designate an allocation, by the creditor; only if neither party exercises its right to allocate the payment does the authority to do so devolve upon the court.[9]

Indeed, the decision in *National Bank of the Commonwealth* has no bearing at all on the issue addressed by the court of appeals. First, as in the earlier cases cited there, the Court in *National Bank of the Commonwealth* appears to address only the question of voluntary payments;[10] that certainly is how the case generally has been understood by lower courts. See, *e.g.*, *S.S. Silberblatt, Inc.* v. *United States*, 353 F.2d 545, 548 & n.9 (5th Cir. 1965); *Jung* v. *United States*, 701 F. Supp. 175,

[8] See *United States* v. *Kirkpatrick*, 22 U.S. (9 Wheat.) 720, 737-738 (1824); *United States* v. *January*, 11 U.S. (7 Cranch) 572, 574-575 (1813); *Field* v. *Holland*, 10 U.S. (6 Cranch) at 27.

[9] This Court stated the rule as follows (94 U.S. at 439):

> The rule settled by this court as to the application of payment is, that the debtor or party paying the money may, if he chooses to do so, direct its appropriation; if he fail, the right devolves upon the creditor; if he fail, the law will make the application according to its own notions of justice.

[10] The payments in *National Bank of the Commonwealth* had been made by a receiver, rather than by the debtor itself. 94 U.S. at 437. But there is no indication that the payments in question were regarded by the Court as any less voluntary than a payment by a solvent debtor; certainly they were not compelled by any statute akin to 11 U.S.C. 1129(a)(9)(C).

176 (E.D. Wis. 1988). Second, the Court in *National Bank of the Commonwealth* did not approve a court-sanctioned allocation that would override the wishes of one of the parties; to the contrary, the Court merely approved the designation made by the debtor. See 94 U.S. at 439. In fact, the Court specifically noted that it "need not * * * consider" what would be an appropriate allocation if it were the duty of the court to make the allocation (*ibid.*).[11]

To the extent these early cases cast any light on a court's authority to designate payments, they suggest that the equitable considerations invoked by the court below do

[11] The legal encyclopedia cited by the court of appeals (Pet. App. 14a) also provides scant support for its broad assertion of bankruptcy court authority. First, that source recognizes a "split of authority" concerning the power of a court to override a creditor's designation of an involuntary payment; the quotation relied upon by the court of appeals thus does not reflect a consensus view. See 60 Am. Jur. 2d *Payment* § 103, at 949 (1987). Moreover, that quotation suggests that any power that a court holds in this regard is confined by the "rights and priorities" of creditors established by statute. *Ibid.* In any event, the same source recognizes that the courts have uniformly approved the IRS's policy of designating involuntary *tax* payments (*id.* § 104), and it does not suggest that this policy is called into question by its more general observations concerning the power of courts to allocate non-tax payments. See also *O'Dell* v. *United States*, 326 F.2d at 456 (court has no power to direct IRS how to apply involuntary payment); *Amos* v. *Commissioner*, 47 T.C. at 68-70 & n.3 (same). *Commercial Credit Corp.* v. *Schwartz*, 130 F. Supp. 524 (E.D. Ark. 1955) (cited at Pet. App. 13a), also lends no support to the decision below. In that case, the IRS apparently had allocated the proceeds of a judicial sale to a tax debt secured by a lien that was *junior* to that of the plaintiff, and therefore the IRS's action was inconsistent with the priority rules that govern distributions from judicial sales. In the instant case, by contrast, the IRS proposes to apply the Chapter 11 payments only to seventh priority tax claims, and therefore the IRS's allocation is fully consistent with the priorities established in the Bankruptcy Code.

not support its decision. In *Field* v. *Holland*, 10 U.S. (6 Cranch) at 28, the Court approved the allocation that had been made in that case, stating that "[i]t being equitable, that the whole debt should be paid, it cannot be inequitable, to extinguish first those debts for which the security is most precarious." Thus, the decision below (requiring the IRS to reduce its chances for total recovery by applying Chapter 11 payments first to those liabilities for which there is an alternate source of collection) is at odds with this Court's expressed view of an equitable allocation of a partial payment to a creditor when the various debts are not equally well secured.

2. There is no provision in the Bankruptcy Code or elsewhere that expressly confers upon the bankruptcy court authority to direct the IRS to apply Chapter 11 priority tax payments first to trust fund liability. The court of appeals held, however, that Congress has conferred "broad equitable powers" upon the bankruptcy courts that authorize them to require the IRS to honor the debtor's requested designation (Pet. App. 13a). This interpretation cannot be sustained. Rather, as the Third Circuit stated, "no provision in the Bankruptcy Code allows either the debtor or the bankruptcy court to direct application of payments and thereby preclude recourse by the United States against responsible parties who serve as guarantors of the United States' claims against the employer" (*In re Ribs-R-Us, Inc.*, 828 F.2d at 203-204).

The court of appeals cited 11 U.S.C. 105(a) as the source of this broad equitable power. That provision empowers the court to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Bankruptcy Code]." In the court of appeals' view, if the responsible officers of the corporate debtor refuse to aid the reorganization unless the priority tax payments under the plan are applied so as to minimize their Section

6672 liability, it is "appropriate"—and hence authorized by Section 105—for a bankruptcy court to direct the IRS to apply Chapter 11 payments first to trust fund tax debts. The court explained that this designation would be proper, even though it concededly would reduce the government's chances of collecting its entire tax debt, because the responsible officers' assistance would help "keep[] the firm alive" and therefore increase the possibility that unsecured creditors ultimately will recover some of the money owed to them. See Pet. App. 13a-14a.

The court of appeals' assertion of bankruptcy court authority rests on a serious misinterpretation of Section 105. That provision does not confer upon the bankruptcy courts unbridled authority to enter any order that would aid the rehabilitation of the debtor. Section 105 of the Bankruptcy Code speaks to the procedural powers of the bankruptcy court. The statute was designed to extend to bankruptcy courts the powers exercised by other courts under authority of the All Writs Act, 28 U.S.C. 1651, as well as other powers traditionally exercised by bankruptcy courts under the old Bankruptcy Act. See H.R. Rep. No. 595, 95th Cong., 1st Sess. 316-317 (1977).[13] Thus, "Section 105(a) simply authorizes a bankruptcy court to fashion such orders as are necessary to further the purposes of the substantive provisions of the Bankruptcy

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[13] Except for two specific changes not relevant here, Congress noted that Section 105 was derived from Section 2(a)(15) of the old Bankruptcy Act, 11 U.S.C. 11(a)(15) (1976), which was even more clearly addressed only to the procedural powers of the court. See H.R. Rep. No. 595, *supra*, at 316-317; 2 L. King, *Collier on Bankruptcy* ¶ 105.01 (15th ed. 1989). That Section provided in pertinent part that bankruptcy courts could "[m]ake such orders, issue such process, and enter such judgments * * * as may be necessary for the enforcement of the provisions of this Act."

Code" (*United States* v. *Sutton*, 786 F.2d 1305, 1307 (5th Cir. 1986) (footnote omitted)). The equitable powers conferred on the bankruptcy courts by Section 105 are to issue orders such as injunctions and stays and to punish contempt in cases where such orders are necessary to implement the substantive provisions enacted by Congress. *Ibid.*; *Bird* v. *Carl's Grocery Co.*, 864 F.2d 593, 595 (8th Cir. 1989).

Section 105, however, "does not authorize the bankruptcy courts to create substantive rights that are otherwise unavailable under applicable law, or constitute a roving commission to do equity" (*United States* v. *Sutton*, 786 F.2d at 1308 (footnote omitted)). See also *Browning* v. *Navarro*, 887 F.2d 553, 559 (5th Cir. 1989); *Bird* v. *Carl's Grocery Co.*, 864 F.2d at 595; *Johnson* v. *First Nat'l Bank*, 719 F.2d 270, 274 (8th Cir. 1983), cert. denied, 465 U.S. 1012 (1984). Rather, the scope of Section 105 is limited; "its broad equitable powers may only be used to further the policies and provisions of the [Bankruptcy] Code" (*Bird* v. *Carl's Grocery Co.*, 864 F.2d at 595). See also *In re* ▪. *Technical Knockout Graphics, Inc.*, 833 F.2d at 803; *Official Committee of Equity Security Holders* v. *Mabey*, 832 F.2d 299, 302 (4th Cir. 1987), cert. denied, 485 U.S. 962 (1988). As this Court stated in another context, "whatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code" (*Norwest Bank Worthington* v. *Ahlers*, 485 U.S. 197, 206 (1988)).

To the extent the court of appeals sought to rest its holding upon a substantive determination by Congress embodied in the Bankruptcy Code, as opposed to a court's generalized notions of equity, it suggested that ordering the IRS to designate priority tax payments so as to minimize the Section 6672 liability of responsible persons furthers "the Bankruptcy Code's preference for rehabilitation over liquidation" (Pet. App. 20a). Although rehabilitation is an important and worthy goal, that goal must be pursued only within the limitations established by the Code that address other, often competing, interests. Therefore, an order cannot be said to be "necessary or appropriate to carry out the provisions of [the Bankruptcy Code]" (11 U.S.C. 105) solely because it may in some fashion increase the likelihood that the debtor will be rehabilitated.[13]

One of the major interests competing with the goal of rehabilitation that Congress weighed in enacting the Bankruptcy Code is the government's interest in the collection of delinquent taxes. Congress recognized that the government often bears the brunt of a failing business's inability to pay all of its creditors (H.R. Rep. No. 595, *supra*, at 193):

> In business cases, * * * it is a frequent occurrence that the business will stop paying its taxes before it stops paying its other creditors, because the officers of the business know that detection of nonpayment is more difficult for the taxing authority than it is for a supplier or lender, and that an unpaid supplier quickly

[13] The Bankruptcy Code does not "constitute a guarantee that all persons who seek reorganization protection under the Code will qualify for it" (*Success Tool & Mfg. Co.* v. *United States Dep't of Treasury*, 62 Bankr. 221, 224 (N.D. Ill. 1986)). A debtor seeking to reorganize under the protection of Chapter 11 must meet the prerequisites established by Congress. See, *e.g.*, 11 U.S.C. 109, 1123, 1129. If the debtor is unable to do so, the bankruptcy court is not empowered to enter orders to help the debtor to reorganize at the expense of the statutory requirements. To the contrary, if the debtor is unable to propose or effectuate a confirmable reorganization plan (*i.e.*, a plan that satisfies the conditions imposed by Congress), the bankruptcy court is obligated to dismiss the Chapter 11 proceeding or to convert it into a liquidation proceeding. See 11 U.S.C. 1112(b).

> stops shipping goods, though an unpaid taxing authority is usually unable to take collection action for months.

See also *id.* at 189-190. Accordingly, Congress acted to protect the revenue in bankruptcy proceedings by providing a priority for specified tax claims, including those at issue in this case, and by making those tax debts nondischargeable. See 11 U.S.C. 507(a)(7), 523(a)(1)(A). Hence, the observation made by this Court about the old Bankruptcy Act is equally applicable today; there has been a "congressional judgment that certain problems—*e.g.*, those of financing government—override the value of giving the debtor a wholly fresh start" (*Bruning* v. *United States*, 376 U.S. 358, 361 (1964)).

The court of appeals also adverted (Pet. App. 15a-16a) to the explicit recognition in the legislative history that the Bankruptcy Code requires a balancing between the competing interests of the debtor, the general creditors, and the taxing authorities. See S. Rep. No. 989, 95th Cong., 2d Sess. 13-14 (1978). But the court of appeals erred in relying upon this general statement to justify its decision here. The Senate Report proceeds to specify the manner in which Congress determined to balance those competing interests—namely, by giving some tax debts priority and making them nondischargeable and by denying that preferred status to other tax debts. See S. Rep. No. 989, *supra*, at 14; see also *United States* v. *Gurwitch*, 794 F.2d 584, 585-586 (11th Cir. 1986) (there is a "clear policy judgment by Congress" favoring collection of priority taxes over the debtor's rehabilitation). Thus, to the extent that dismissal of the Chapter 11 proceedings or a conversion to liquidation would cause general unsecured creditors to go unpaid, while allowing priority taxes to be collected from

available funds, that result is deliberately mandated by Congress.[14]

There is no suggestion that Congress thought it appropriate to deviate from this priority scheme by conferring upon the bankruptcy court the power to designate tax payments, to the detriment of the IRS's ability to collect delinquent taxes, in order to entice responsible persons to release claims against the debtor or to cooperate in obtaining financing. It is undoubtedly true that the success of a reorganization may be jeopardized if the debtor's officers are, for whatever reason, unwilling to cooperate fully in the reorganization. But that does not give the bankruptcy court carte blanche to enter orders designed to secure such cooperation by assisting the officers at the expense of another party to the bankruptcy. The bankruptcy court must accept the manner in which Congress has balanced the competing interests in bankruptcy; it cannot upset that balance by ordering the IRS to make an allocation designed to advance, at the government's expense, the interests of general creditors (see Pet. App. 14a).

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[14] The discussion in the Senate Report marked by the ellipsis in the court of appeals' quotation (Pet. App. 15a) is highly relevant, since it emphasizes and explains the importance that Congress attached to the satisfaction of delinquent tax claims in bankruptcy. The Report states (S. Rep. No. 989, *supra*, at 14):

> [T]ax collection rules for bankruptcy cases have a direct impact on the integrity of the Federal, State and local tax systems. These tax systems, generally based on voluntary assessment, work to the extent that the majority of taxpayers think they are fair. This presumption of fairness is an asset which should be protected and not jeopardized by permitting taxpayers to use bankruptcy as a means of improperly avoiding their tax debts. To the extent that debtors in a bankruptcy are freed from paying their tax liabilities, the burden of making up the revenues thus lost must be shifted to other taxpayers.

3. In addition to its departure from Congress's carefully considered balancing of interests in the Bankruptcy Code, the decision below would substantially undermine congressional policies embodied in the Internal Revenue Code. A bankruptcy court's designation of priority tax payments for application first to the corporation's trust fund liabilities is directly "in derogation of Congress' strong policy, reflected in Section 6672, to protect the government's tax revenues by insuring an additional source from which trust fund taxes can be collected" (*In re Ribs-R-Us, Inc.*, 828 F.2d at 204). As we have discussed (pp. 17-18, 31-32, *supra*), Congress recognized the danger that officers of struggling businesses could be tempted to use withheld tax funds in an attempt to ease temporarily their financial difficulties.[15] Therefore, the personal liability imposed by Section 6672 for failure to remit trust funds to the government is critical to the integrity of the withholding tax system, in that it provides a deterrent to the conversion of trust funds and an alternate source of collection if they are misused.

Clearly, the deterrent effect of Section 6672 and its value as an alternate source of collection would be greatly diminished if a responsible person could raid the trust fund and then nonetheless avoid his individual liability for the unpaid taxes through bankruptcy proceedings. Accordingly, Congress generally has been careful to preserve

[15] See also *United States* v. *Sotelo*, 436 U.S. 268, 277 n.10 (1978) (quoting Marsh, *Triumph or Tragedy? The Bankruptcy Act Amendments of 1966*, 42 Wash. L. Rev. 681, 694 (1967)): "It is a common phenomenon of business failure that even an 'honest' businessman, in attempting to salvage a business which appears headed for insolvency, will frequently 'borrow' money of other people without their consent if he can get his hands on it. The one fund which he is almost always able to lay his hands on is the taxes he has withheld and is currently withholding from his employees for the Government."

the efficacy of the Section 6672 protection in its bankruptcy legislation. For example, Section 6672 liability is given priority and is not dischargeable in a responsible officer's personal bankruptcy proceeding. See 11 U.S.C. 507(a)(7)(C), 523(a)(1); *United States* v. *Sotelo*, 436 U.S. at 275-280 (Bankruptcy Act). This rule was designed to address the Treasury Department's specific concern that it is "most undesirable to permit persons who are charged with the responsibility of paying over to the Federal Government moneys collected from third persons to be relieved of their obligations in bankruptcy when they have converted such moneys for their own use" (*id.* at 276 (quoting S. Rep. No. 114, 89th Cong., 1st Sess. 10 (1965)). Compare *Kelly* v. *Robinson*, 479 U.S. 36 (1986).

Against this background, the district court in *Newport Offshore* is surely correct in stating that Congress "did not ever intend that a principal stockholder of a corporation in reorganization would have the ability to negotiate in the Bankruptcy Court an exculpatory provision with respect to the trust fund taxes" (Pet. App. 29a-30a). It is not appropriate for the bankruptcy court to permit the same officers—through the threat of noncooperation with the corporate debtor's reorganization—to achieve personal relief in the corporate bankruptcy proceedings that they could not obtain in their own bankruptcy proceedings.[16]

[16] The courts have consistently rejected the attempts of responsible persons to use corporate bankruptcy proceedings to shield themselves from Section 6672 liability. A bankruptcy court presiding over corporate bankruptcy proceedings may not enjoin the assessment or collection of the Section 6672 liabilities of the debtor's responsible persons. See *LaSalle Rolling Mills, Inc.* v. *United States*, 832 F.2d 390 (7th Cir. 1987); *A to Z Welding and Mfg. Co.* v. *United States*, 803 F.2d 932, 933 (8th Cir. 1986); *United States* v. *Huckabee Auto Co.*, 783 F.2d 1546, 1548 (11th Cir. 1986). The courts have also held that the government is not required to exhaust its remedies against the cor-

Moreover, this Court has held that a court generally may not require the United States to take into account the interests of sureties or guarantors in deciding how to allocate partial payment of a debt due to it; rather, the United States is free to make the allocation in its own fiscal interest even if that allocation perpetuates the third party's potential liability. *Jones* v. *United States*, 48 U.S. (7 How.) 681, 688, 691-692 (1849); *United States* v. *Giles*, 13 U.S. (9 Cranch) 212, 241 (1815); see also 60 Am. Jur. 2d *Payment* § 126 (1987). Even if the rule were otherwise for sureties that are blameless and only secondarily liable, it would seem clear that an officer subject to Section 6672 liability—who breached the statutory trust and whose liability is not secondary, but rather is distinct from that of the corporation—should not be entitled to relief from liability by forcing the IRS to apply the corporation's partial payment against the government's fiscal interest.

There can be little doubt that permitting the bankruptcy court to order designation of Chapter 11 tax payments first to trust fund taxes would seriously undermine Section 6672. The value of the provision as a deterrent to the conversion of trust funds in the first place would manifestly be weakened if the responsible officers had reason to believe they could ultimately escape personal liability under cover of Chapter 11. And, contrary to the suggestion of the court of appeals (Pet. App. 18a-20a), the designation orders approved here also would undermine the value of Section 6672 as a guarantee for collection of

porate debtor before making a Section 6672 assessment against a responsible person. See, *e.g.*, *Calderone* v. *United States*, 799 F.2d 254, 257-258 (6th Cir. 1986); *Hornsby* v. *IRS*, 588 F.2d 952, 954 (5th Cir. 1979). And a responsible person who has paid his Section 6672 liability has no right to reimbursement or contribution from the corporate debtor. *Levit* v. *Ingersoll Rand Financial Corp.*, 874 F.2d 1186, 1191-1192 (7th Cir. 1989).

delinquent trust fund taxes. To be sure, the designation would mean that the trust fund tax liability would be eliminated on the IRS's books sooner than if the Chapter 11 payments are applied first to non-trust fund taxes. But the revenue protection policy of Section 6672 is not designed to achieve an accounting goal of assuring that tax dollars collected will be placed in the trust fund column, rather than the non-trust fund column. Rather, the statute is intended to protect the Treasury from a loss—by providing an alternate source of collection from the persons responsible for misusing the funds held in trust for the government.

Under the court of appeals' decision, Section 6672 would no longer protect the Treasury from a loss. As the court of appeals acknowledged (Pet. App. 20a), dollars are "fungible," and there is therefore no reason for Congress or the Treasury to prefer the collection of a dollar of trust fund liability over a dollar of non-trust fund liability. As the court of appeals also acknowledged (*id.* at 14a), its designation policy would actually decrease the likelihood that the Treasury will collect the delinquent taxes because it would postpone collection of the unguaranteed non-trust fund taxes, putting that debt at risk that the reorganization plan will not be successfully completed.[17]

[17] This forced postponement of the collection of the non-trust fund liability is particularly inappropriate in light of the fact that funds withheld for the collection of taxes are required to be held in trust for the government and thus should never become the property of the corporation. In recognition of this special status, the Bankruptcy Code provides that withheld taxes still in the debtor's possession are not even included in the property of the estate that is available to be used in the reorganization. See 11 U.S.C. 541(d). Thus, it is only because the responsible persons here not only failed to pay over the trust funds to the government, but also dissipated the trust fund itself, that satisfaction of the trust fund liability has become a matter that must

Thus, while it is technically true that the designation would not reduce the collection of *trust fund taxes*, that collection would be accomplished only by, in effect, substituting another pocket of the Treasury (its non-trust fund taxes) in place of the guarantors established by Congress in Section 6672—the persons responsible for the creation of the trust fund delinquency. It would thus frustrate the intent of Section 6672 to require the government to collect its trust fund taxes at the expense of the other taxes owed to it (a shortfall that Congress recognized would ultimately be borne by other taxpayers (see note 14, *supra*))—for the express purpose of relieving the corporation's responsible persons of the liability imposed on them by Section 6672.[18] There is, in sum, no proper authority for the bankruptcy court to require a designation that is so inimical to the congressional design embodied in both the Bankruptcy Code and the Internal Revenue Code.

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be addressed by the Chapter 11 plan. If the responsible persons' malfeasance had been less extreme, the only priority tax payments to be made under the plan would have been those of the non-trust fund taxes, which the bankruptcy court would have no reason to postpone until the end of the reorganization.

[18] As we explained in our reply at the petition stage (at 3-5), the court of appeals erred in suggesting (Pet. App. 20a) that the government can protect itself from loss by seeking to collect from the responsible persons as quickly as possible. Quite apart from the fact that this approach would appear to defeat the court of appeals' professed goal of encouraging those persons to cooperate with the reorganization, this approach would not adequately protect the government's tax collection prospects. Even if Section 6672 liability is assessed against the responsible person, he can delay its collection by paying a small portion of the claimed liability, posting a bond, and then filing a claim for refund—thereby allowing the designation provision to operate to eliminate his separate liability. Moreover, even if the trust fund delinquency is collected from him, the responsible person still has a considerable period within which to seek a refund, during which time the designation provision will continue in force.

CONCLUSION

The judgments of the court of appeals should be reversed.

Respectfully submitted.

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